Newsletter: January 2025

We began our most recent newsletter, from October 2024, by describing why we were not implementing changes in our clients' portfolios specifically in anticipation of the November elections. We tend not to own businesses whose performance is substantially affected by policies that are subject to change from one administration to the next. Furthermore, accurately predicting actual policy changes is inherently difficult and hence not an area where we are likely to achieve a high degree of analytical conviction. We believe that our portfolio companies can create value over a long period of time and in a variety of economic and political conditions, and our expectation that these businesses will be significantly more valuable in 5-10 years' time is largely independent of any given electoral outcome.[1]

Following the November elections there was an approximately month-long broad-based rally in the equity market, some of which seemed to be driven by hardheaded policy-related considerations—for instance, the potential for fewer and less burdensome regulations and for lower tax rates, and the corresponding positive impacts on after-tax corporate earnings growth. And yet there also seemed to be a resurgence of investor exuberance, a kind of renewal of "animal spirits," that could be observed not only in the equity market but also in surveys of small business sentiment, corporate credit spreads, and the price of bitcoin.[2] Without animal spirits there would be no entrepreneurialism or other economic risk-taking, but in financial markets their waxing and waning can lead to asset prices temporarily overshooting or undershooting underlying intrinsic values.

In mid-December, the Federal Open Market Committee (FOMC) reduced the fed funds rate by another quarter-point, bringing the cumulative reductions since mid-September to a full percentage point, from a starting range of 5.25-5.5%, which had been in effect since July 2023, to the current range of 4.25-4.5%. Unusually, however, while the fed funds rate moved lower in recent months, yields on longer-term Treasury securities moved significantly *higher.* Longer-term Treasury yields primarily reflect expectations regarding longer-term economic growth and inflation. Many of the same policy-related considerations that contributed to equity market strength in the wake of the November elections have likely positively influenced expectations regarding economic growth. At the same time, market-derived inflation expectations have also increased.[3] This may appear somewhat puzzling given that the decline in *measured* inflation, from more than 9% in the summer of 2022 to less than 3% by the summer of 2024, was the principal basis for the FOMC's decision to begin reducing the fed funds rate in September.[4]

So what is the market thinking? There are probably at least two perspectives at work. First, given continued economic growth, a still strong labor market, and "easy" financial conditions (including tight corporate credit spreads and an equity market near its all-time high), the former fed funds range of 5.25-5.5% was arguably not

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[1] For our October 2024 newsletter and other client newsletters, please see our website: https://beckmack.com/.

[2] John Maynard Keynes, in his "General Theory of Employment, Interest and Money" (1936), revived, but (contrary to popular belief) did not originate, the phrase "animal spirits." See "Animal Spirits" (2023) by Jackson Lears.

[3] Inflation expectations can be derived from the yields on Treasury securities and the yields on corresponding Treasury inflation-protected securities (TIPS), which pay the stated yield plus an amount that corresponds to changes in the Consumer Price Index.

[4] References to measured inflation are to the Consumer Price Index.

particularly restrictive and therefore did not need to be adjusted, especially since inflation is still above the preferred level of approximately 2%. Second, there also seems to be a growing awareness of the fiscal imbalances (i.e., budget deficits) we discussed at some length in our October 2024 newsletter—imbalances that, absent politically unpopular corrective action, will naturally worsen due to factors such as population ageing and its impact on Social Security and Medicare outlays and, moreover, that could potentially worsen as a result of the fiscal policies of the incoming administration. As we have previously discussed, an environment characterized by some combination of faster or more volatile inflation and by higher or more volatile nominal interest rates presents challenges to investing in bonds with any but the shortest durations. Within equities, these characteristics privilege businesses with pricing power, strong balance sheets, and smart capital allocation—which are essential underwriting criteria that Beck Mack + Oliver selects for in any environment.

At the FOMC meeting in mid-December, the committee signaled fewer reductions to the fed funds rate over the course of 2025 and 2026 than it had signaled at its September meeting, as it recognized some of the issues discussed above. The subsequent negative reaction in the equity market offset a good portion of the post-election rally, such that between election day and the end of the year, the S&P 500 was up less than 2%. For all of 2024, the S&P 500 was up 25%. Over the last two years, the S&P 500 is up 58% cumulatively, or 26% on an annualized basis, its best performance over two consecutive calendar years since 1997-1998, which may strike many as an unsettling precedent. There are some notable differences, however, between that period and our own. The S&P 500 generated an astounding 29% *annualized* total return during the five-year period of 1995-1999, before entering a bear market in the early 2000s. Over the five-year period of 2019-2024, the S&P 500 has generated an annualized total return of not quite 15%, and over the last three years its annualized return is less than 9%. This compares to longer-term annualized returns for the S&P 500 of approximately 11%, 12%, and 12% over the last 30, 40, and 50 years, respectively.

More actionable from a stock-picking perspective perhaps is the ongoing dispersion between stocks with respect to market capitalization, with large cap stocks continuing to outperform their smaller counterparts by an extraordinary margin. In prior newsletters, we have discussed the difference between the S&P 500, whose constituent stocks are weighted by market cap, and the S&P 500 Equal Weight, which has the same constituent stocks but equally weighted. A year ago, we noted that the more than 12% margin by which the S&P 500 outperformed its equal weight counterpart in 2023 was the largest such margin of outperformance in a calendar year since 1998. Far from reversing, this trend powerfully persisted in 2024, when the S&P 500 outperformed the S&P 500 Equal Weight by another 12%. There are some fundamental factors at play, such as the increasing importance of scale in certain industries, especially capital-intensive technology related to artificial intelligence. But there are also technical factors at play, such as the continued spread of passive investing, particularly exchange-traded funds (ETFs), momentum-driven and mimetic behavior among active investors (e.g., the fear of missing out on NVIDIA stock), and the inherent momentum of market cap-weighted indices such as the S&P 500, whereby market cap increases lead to greater weights in the index, which in turn attract a greater portion of every new dollar that flows into products, such as ETFs, that track the index, which in turn leads to market cap increases, etc. The upshot is that a progressively *larger* portion of the index's overall return is generated by a progressively *smaller* set of large-cap stocks. While the fundamental factors influencing these market conditions may persist, we believe the technical factors are likely to reverse at some point. In any event, on balance we seem to be finding more interesting or mispriced opportunities, both within our existing portfolio and in regard to prospective new investment ideas, among small and midcap stocks.

As we kick off 2025, below is an incomplete list of some of the questions and themes that the Beck Mack + Oliver investment team is actively researching or that are otherwise likely to influence the performance of companies that we own or are following in the coming year and beyond:

- As large technology companies—such as Alphabet (Google), Amazon, and Microsoft—make enormous capital investments related to artificial intelligence, including semiconductor chips and data centers, will the *return* on all of this investment exceed the cost of capital? If not, how will we know, and how quickly will management teams recalibrate their investment levels? If only a handful of businesses can afford to spend these massive amounts, will that simply deepen the competitive moats of incumbents, or will the rise of artificial intelligence disrupt and fragment existing industry structures?
- Notwithstanding the robust growth in revenue generated in recent years by the public cloud service providers, including the three companies mentioned above, is the equity market potentially underestimating the length of the runway for this revenue stream?
- How much additional traction will the alternative asset managers, such as Apollo and Blackstone, gain in the private wealth or retail channel, whose collective assets are vast but today still largely reside outside the alternative asset ecosystem?
- What kind of performance should we expect from the various alternative asset managers-cum-insurance companies that have followed in the wake of Apollo's tremendous success with its insurance business Athene? Will a potential negative event involving annuity holders at a single company draw heightened regulatory or legislative scrutiny to the entire industry? After the heady growth of the annuities industry in recent years, what is a reasonable growth assumption for the next 5-10 years?
- How successfully will Arthur J. Gallagher integrate AssuredPartners, especially with respect to broker retention and technology systems, and will Gallagher be able to accelerate organic revenue growth at the acquired business?
- Will the so-called "normalization" of consumer credit trends, particularly in credit card and auto loan portfolios, equilibrate at manageable levels or eventually turn into a financial problem for lenders and perhaps even a macroeconomic headwind? What are the associated risks and opportunities for businesses such as American Express, Credit Acceptance, and JPMorgan?
- Will "cash sorting"—i.e., the reallocation of cash into higher-yielding alternatives such as money market funds—begin to taper off now that short-term interest rates are lower than they were several months ago?
- With Ameritrade now fully integrated, can Charles Schwab's net new asset growth return to its historical target of 5-7%?
- Will commercial real estate transaction volumes and valuations improve? Will growth in CoStar's core commercial offering reaccelerate, and what kind of progress can we expect in the company's residential effort? Will Zurn Elkay's substantial exposure to non-residential institutional end-markets continue to contribute to resilient overall organic growth?
- To what extent will the incoming administration attempt to modify regulations or policies affecting the healthcare industry, and more specifically what are the potential impacts on clinical trials (Fortrea), clinical labs (Labcorp), medical devices (Abbott Labs), and life sciences (Waters)?
- Artificial intelligence has already demonstrated tangible benefits to the field of radiology, where Radnet continues to innovate; how long until it can demonstrably improve something like drug discovery?
- What will prove to be the magnitude and timing of revenue generation, for companies such as Ashtead and Ferguson, related to infrastructure-related spending sponsored by the Inflation Reduction Act and similar legislation? Separately, will these businesses' respective end-markets, some of which have cyclical characteristics, perform as management expects?
- To what extent will heavy-duty truck sales begin to recover in 2025 due to some combination of a cyclical recovery in the freight market and truck buying in advance of upcoming regulatory changes? How will the

mostly acyclical aftermarket business of Rush Enterprises perform in different scenarios corresponding to new truck sales and the broader freight market?

- The volume of existing home sales is near a 14-year low due in part to the “lock-in” effect of outstanding mortgages with low fixed rates. Which companies would benefit most from a cyclical reversion to the mean in existing home sales, and of those which are otherwise great businesses that we would want to own for a long period of time?
- As artificial intelligence is applied to the field of robotics, what are the opportunities and best positioned businesses in the technology, industrial, and other sectors?

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